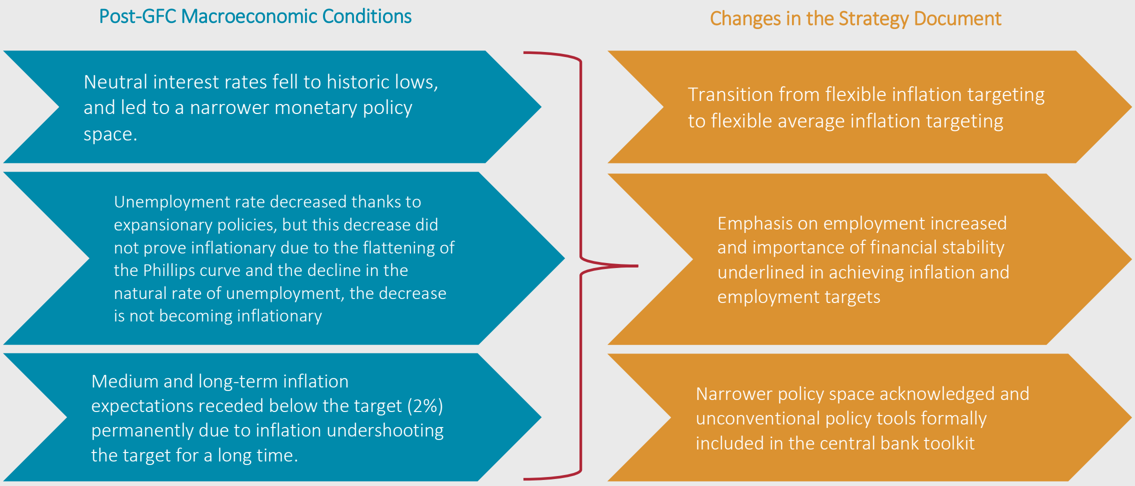
Box 2.1

Fed's New Policy Framework and Its Possible Impact on Developing Countries

The Fed updated its strategy document, announced while officially shifting to inflation targeting in 2012, and became the first major central bank to make significant changes in its policy framework after the Global Financial Crisis (GFC). The new strategy text summarizes the post-GFC macroeconomic conditions and includes innovations in the policy framework (Figure 1).[1] Keeping the dual target approach and the inflation target of 2% intact, the most important innovation that the review has introduced is the transition to average inflation targeting.

Figure 1: Macroeconomic Conditions and Changes in the Fed's Statement on Longer-Run Goals and Monetary Policy Strategy

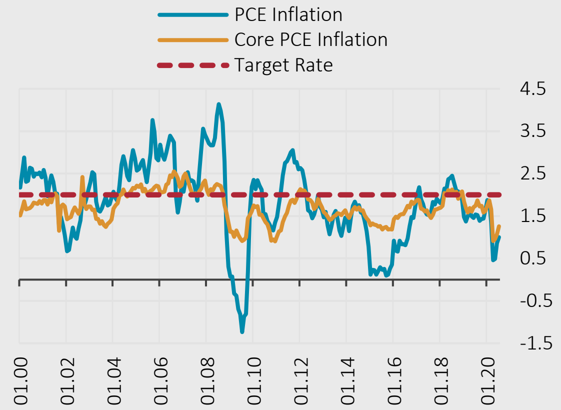


The Fed had two key observations regarding the post-GFC economic conditions. The first is the distinct decline in neutral interest rates, and the second is core inflation, which remained below the target rate despite all expansionary policies (Chart 1). Inflation hovering below the target for a long time shapes expectations in this direction in the medium and long term. Formation of expectations in this way further reduces inflation by deferring consumption and can turn into a cycle that limits economic growth, as has been the case in the Japanese economy for a long time. Expectations below the target also reduce the long-term equilibrium value of the nominal policy rate together with the low neutral real interest rate and neutralize the monetary policy by narrowing the policy area (Chart 2). The main purpose of the Fed's framework change is to protect the economy from the aforementioned cycle by increasing inflation expectations and to increase the effectiveness of the monetary policy in cases where the zero lower bound for interest rates is binding.

This blockage in monetary policy has long been debated among developed country policy makers and in the economic literature. In this context, some "supportive strategies" have been proposed to strengthen conventional inflation targeting's ability to tackle the "zero lower bound" and "lower-than-target inflation".[2] Among these strategies, the Fed preferred the "average inflation targeting" framework among options such as "nominal GDP targeting" and "price level targeting".

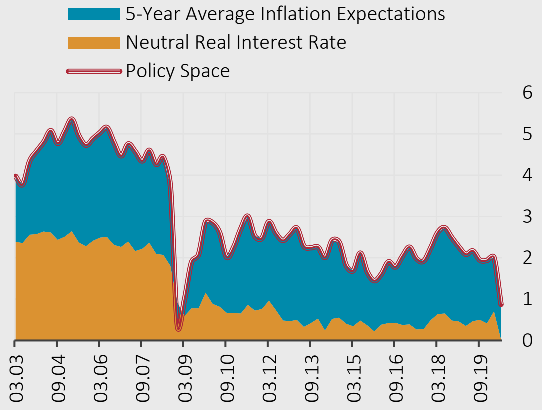
[1] For the new strategy document and the changes made, see Fed (2020a) and Fed (2020b).
[2] For global monetary policy change and supportive strategies, see Yavuz (2017).

Chart 1: Annual Inflation Rate in the USA* (%)



Source: St. Louis Fed.

Chart 2: Neutral Interest Rate, Inflation Expectations and Policy Space in the USA** (% Points)



Sources: HLW (2017), Philadelphia Fed.

* PCE (Personal consumption expenditures) inflation.

** Neutral real interest rates are from the Holston, Laubach and Williams (2017) study, and inflation expectations from the Philadelphia Fed survey. The long-term equilibrium value of the nominal interest has been calculated by adding the neutral real interest rate and inflation expectations. This value also refers to the maximum reduction that can be made in the policy rate during a recession, and therefore, to the policy space.

Supportive Strategies and Average Inflation Targeting

Conventional inflation targeting is concerned with responding to the deviations of inflation from the medium-term target. Periods in which inflation hovers below or above the target are considered as having happened “in the past” and when the trend of inflation becomes consistent with the target, a policy shift takes place to maintain this trend, taking into account the lag in monetary policy transmission. It is safe to say that such policy ensures price stability in the long run and achieves an inflation rate of around 2%, unless inflation deviates sharply from the target or the deviations follow the same direction for a long time. However, as the magnitude or the duration of deviations increases, the average value of inflation differs considerably from 2%.

In the proposed supportive strategies, deviations from the target are no longer considered “in the past” and are compensated for. For example, when nominal GDP is targeted, either higher inflation or higher output will be needed to achieve the target after a period in which inflation remains below the target. Again, when the price level is targeted, all deviations will need to be fully compensated for in order to achieve a price level compatible with 2%inflation. When average inflation is targeted, deviations from the target should be compensated for in the opposite direction to keep the average. Being more flexible and practical, average inflation targeting is preferred among these strategies (Svensson, 2020).

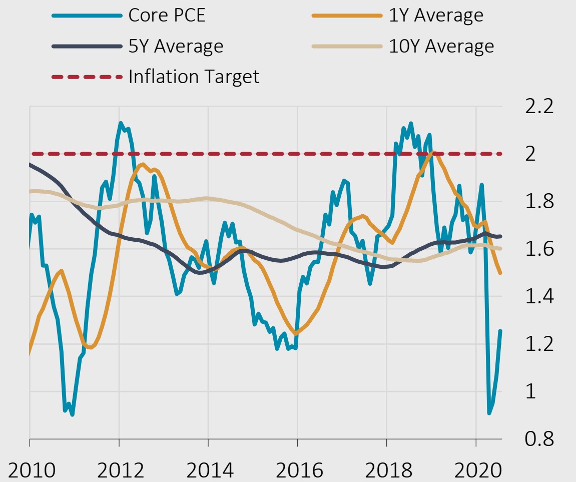
This framework will allow the Fed to let inflation overshoot the target for a reasonable duration, after a period in which inflation has long hovered below the target, as has been the case recently. Thus, the Fed, without conflicting with its inflation objective, will still be able to support the labor market when the economy enters a recovery period. Moreover, if the policy proves reliable, it will provide extra space for the squeezed monetary policy. At present when the policy rate is close to the zero lower bound, if households and firms believe that the Fed will keep inflation above 2% in the upcoming period, inflation expectations will increase and the Fed will have reduced the real interest rate without changing the policy rate at all. This situation may accelerate the recovery of the economy from recession. What should be noted here is that the Fed emphasized that it still cares about inflation and will not avoid intervening in excessive increases.

Comments on Average Inflation Targeting and Possible Implications for Emerging Markets

The Fed's statement that it will target an inflation rate above 2%in the short term and use all the tools in this direction involves a determination to maintain the "accommodative" policy for a longer period of time. In this regard, while the policy rate is not expected to change for a long time (at least until the end of 2023, according to the median projections of FOMC members), it is estimated that other expansionary policy tools will remain in place. In this context, it can be inferred that the policy normalization process is delayed at least for a while and the monetary policy will not have a constraining effect on global liquidity in the near future. This situation may be a positive "push" factor for developing countries in terms of portfolio flows.

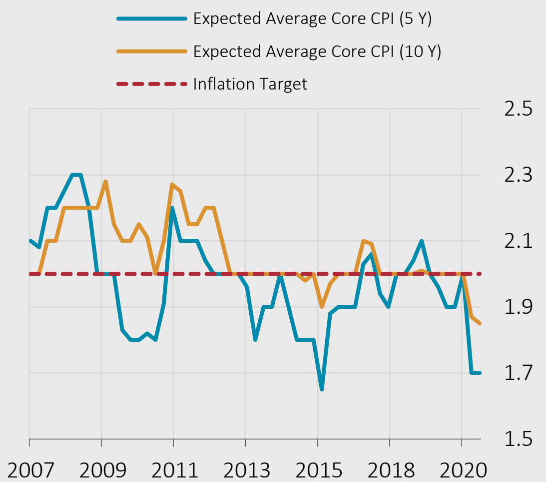
Average inflation targeting has the potential to be more effective in terms of expectation management compared to inflation targeting during the periods of recession and when inflation is below the target for a long time. On the other hand, the new policy framework has brought about a number of uncertainties in terms of communication and expectation management. For example, uncertainties remain as to tolerance limits on how much and for how long the inflation will be allowed to exceed the target and when the Fed will act in view of the natural rate of unemployment. Frequent adjustments to the policy may increase the policy uncertainty, deteriorate the household and real sector expectations and eventually cause the target to lose its reference characteristic. Considering that the average inflation paths calculated in different windows may remain quite different from the target, which maturity averages will be targeted will determine what magnitude of “compensation” will be required (Chart 3).

Chart 3: Core PCE and Its Moving Average Values (%)



Source: Bloomberg.

Chart 4: US Inflation Expectations (%)



Source: Philadelphia Fed.

Uncertainty that may arise in terms of the Fed's new policy in the upcoming period is considered a very important risk factor for the markets. While Chairman Powell's statements at the FOMC meeting in September did not provide a clear answer to the questions about such uncertainties, they gave rise to new ones. As the effects of the pandemic prevail along with high uncertainty, the Fed refrained from making more binding promises in terms of its policy. The surveys conducted in this context also reveal the doubts about the Fed's ability to achieve its newly-defined target among market participants (Chart 4).

In summary, the policy uncertainty in question may cause fluctuations in global markets and portfolio flows to developing countries, which may further be increased by possible conflicts between market expectations and the Fed's policy. This is judged as a factor that may adversely affect exchange rate volatility in developing countries.

References

Holston, Laubach and Williams (2017). “Measuring the Natural Rate of Interest: International Trends and Determinants”, Journal of International Economics, 108, 39–75.

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